252(d)(1) requires the Commission to set rates on the basis of actual, i.e., historical, embedded costs of providing the unbundled network elements. In construing a word whose meaning is in dispute, courts examine the general consensus evidenced by usage, such as dictionaries, (MCI, 114 S.Ct. at 2229-30), and "contextual indications," (Id. at 2229) - - that is, the effect that various interpretations would have on achievement of the purposes of the relevant statute. The starting point is the ordinary meaning of the term Congress used. Where a dictionary consensus exists, a court may conclude, as the Supreme Court did in MCI, that there is "not the slightest doubt that [the ordinary meaning] is the meaning the statute intended. (Id. at 2230).

Here, Congress used the noun "cost." The most common, fundamental, plain-language definitions of the word address the "price to be paid to acquire" something, as in "an outlay or expenditure of money, time, labor, trouble, etc."[17] Moreover, Congress clarified by writing "the cost of providing." This phrase in general usage commonly means the expenses in fact incurred by someone to make something available to another.

The TELRIC approach adopted by the Commission, however, is based on a competitor's expense to replicate a hypothetical, most efficient network. Interpreting "the cost of providing" to mean "the cost of providing a hypothetical, most-efficient replacement network" requires the addition of modifiers that Congress did not include in the statutory language.

[17] The Random House Dictionary of the English Language (2d ed. Unabridged 1983). See also, Black's Law Dictionary (5th ed. 1979) ("Expense; price. The sum or equivalent expended, paid or charged for something"); Webster's Ninth New Collegiate Dictionary (1983) ("the amount or equivalent paid or charged for something" and "outlay or expenditure"); Webster's New Twentieth Century Dictionary (2d ed. Unabridged 1979) ("the amount spent in producing or manufacturing a commodity;" "the amount of money, time effort, etc. required to achieve an end").

Had Congress intended that state commissions use an incremental cost approach like TELRIC, it would have explicitly so required as it did in the Interstate Commerce Commission Act. (See, National Railroad Passenger Corp. v. ICC, 610 F.2d 865, 868, 870 - 872 (D.C. Cir. 1979)) (discussing portion of the ICC Act, 45 U.S.C. Section 562(a), where Congress required the use of an incremental cost standard). But Congress did not provide for an incremental cost measure in Section 252 of the FTA. Congress could also have specified "replacement cost" as it did in other statutes. (See, U.S. v. Kaylor, 877 F.2d 658, 660 (8th Cir.) (Citing 18 U.S.C. Section 2118(a), providing for a "replacement cost" measure), cert. denied 110 S.Ct. 198 (1989)). But again, it did not. Rather, Congress wrote "the cost of providing" without any of the modifiers it included in those other statutes.

In setting rates, regulatory agencies must apply the relevant statutory standard. Courts allow application of the broad "just and reasonable" standard only when the statute does not specify a more explicit basis for determination of just and reasonable rates. As stated in Ohio Power Co. v. FERC, 954 F.2d 779, 784-85 (D.C. Cir. 1992), cert. denied, 113 S.Ct. 482 (1992):

> Of course, it is black letter law that when a conflict arises between specific and general provisions of the same legislation, the courts should give voice to Congress's specific articulation of its policies and preferences. 2A NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION §46.05, at 105 n.19 (5th ed. 1992). Accordingly, we hold that Congress in §13(b) of the PUHCA authorized the SEC to set the price of SOCCO coal "at cost," and in so doing constrained FERC from altering that price under its "just and reasonable" rate-setting authority.

The "cost of providing" is a well understood principle frequently used to establish rates. In Alabama Elec., Coop. Inc. v. FERC, 684 F. 2d 20, 27 (D.C. Cir 1982), the court wrote that "it has come to be well-established that [utility] rates should be based on the cost of providing service . . . plus a just and fair return on equity." Southwestern Bell's costs have been recorded and subjected to regulatory review at both the interstate and intrastate level under long-established accounting rules. (Cooper Affidavit, paras. 2-7). Those costs are readily accessible and may be determined without the necessity of an extended rate proceeding, and can be used as the basis for establishing Southwestern Bell's cost of providing network elements to competitors.

The plain language interpretations of "cost" and "cost of providing" are supported by dictionary definitions, the ordinary uses of the "cost of providing" phrase by the United States Supreme Court, and by the evidence of Congress' ability to write statutes that include the sorts of items it did not include in Section 252. Although there is not "the slightest doubt that [the ordinary meaning] is the meaning the statute intended" (MCI, 114 S.Ct. at 2230), the plain language reading is also the only one that gives full effect to the balance of policies contemplated by Congress.

Given that one of the purposes of the FTA was to encourage the construction of new fully-competitive networks, TELRIC is simply the wrong tool for the task. TELRIC calculates a pricing level where prices are so low that they discourage facilities-based competition.

Substituting a valuation mechanism, like TELRIC, for the incumbent's "cost of providing" distorts the FTA by allowing an overnight devaluation of decades of investments by incumbent carriers. The Final Order creates a system where AT&T and MCI will obtain the use of Southwestern Bell's property at prices that effectively constitute a taking. To adopt a hypothetical valuation measure like TELRIC to establish the "cost of providing" network elements under Section 252 is an interpretation that goes "beyond the meaning that the statute can bear." Competing providers may choose to provide service in whole or in part through the placement and use of their facilities or through resale. If these providers choose to use unbundled network elements from Southwestern Bell, they should expect to pay the costs Southwestern Bell incurs to provide the elements, not a cost of a hypothetical network the carrier could install themselves.

B. The Commission's TELRIC Approach Improperly Used Forward-looking Costs of a Hypothetical Network Rather than the Real Forward-looking Costs of Southwestern Bell's Existing Network.

The Commission's determination of "permanent" rates in the Final Order is improper for another reason. Even assuming its use of a forward-looking costing approach like TELRIC costs was appropriate (which it is not), the Commission improperly looked to a hypothetical network, not to the forward-looking costs of Southwestern Bell's own network.

Rather than focusing on Southwestern Bell's forward-looking costs to provide the requested interconnection and facilities over the network that actually exists, Staff adjusted many of Southwestern Bell's cost model inputs. While the specific adjustments and the reasons they are improper are set forth in Section III of this Motion, the effect of the Commission's approach is to ignore the way Southwestern Bell's network is actually constructed. The specific adjustments merely exacerbate the underlying problem -- the TELRIC model simply does not fairly represent the network Southwestern Bell will be using. Instead, it reflects a perfectly efficient, latest-technology network. That network does not exist, either in Missouri or anywhere else. As a result, the prices developed from this model and adopted by the Commission bear no relation to the actual forward-looking costs of the network Southwestern Bell will be using to provide interconnection and facilities to AT&T and MCI.

Even if forward-looking economic costs were to be used, they should be compared with and validated against the historical book costs which reflect the actual network facilities used to provide service to Southwestern Bell's customers. This "sanity check" would ensure that the rates established are in fact sufficient (as required by the FTA) to permit Southwestern Bell to recover its own forward-looking costs. The comparison presented by Southwestern Bell, of actual costs to the Commission's hypothetical costs, shows that the Commission's prices are not sufficient to run the network. (See, Cooper Affidavit, para. 8). Among the many reasons for the deficiency of these hypothetical costs are that they do not include or reflect the costs incurred to provide sufficient facilities or investment levels required to efficiently serve future customers, nor do they provide for existing Southwestern Bell carrier of last resort responsibilities. (Ibid.; Bailey Affidavit, para. 3).

This unprecedented pricing methodology does not comport with Section 252's directive that rates must be grounded in the "cost . . . of providing" facilities. Nor does this methodology -- which will necessarily underestimate Southwestern Bell's costs in running its real-world network -- give Southwestern Bell any hope of obtaining a "reasonable profit." No case has been cited by the Commission upholding the practice of setting a utility's rates based on a subset of the costs of operating a make-believe network containing perfectly efficient facilities.

The Final Order does not justify limiting Southwestern Bell's recovery to a subset of its costs. But that is what the Commission has done here by excluding Southwestern Bell's actual, prudently incurred historical costs -- costs that Southwestern Bell has incurred to meet the extensive service obligations imposed by the Commission. By chopping off this whole category of legitimate expenses, the Commission has ensured that Southwestern Bell will never be able to recoup its "cost . . . of providing" interconnection and network elements.

C. The Commission's Approach, Which Guarantees Under Recovery of Southwestern Bell's Actual Cost of Providing the Requested Facilities, Works an Unlawful Taking.

Such a methodology will systematically understate Southwestern Bell's costs, and thus will inevitably prevent Southwestern Bell from recovering all its expenses. The impact of the Commission's methodology and the prices it creates are aptly demonstrated in William Bailey's affidavit. If Southwestern Bell's competitors served its existing customers via unbundled network elements, the unbundled network element prices will cause Southwestern Bell to earn no profit and underrun its costs by $335 million. (Bailey Affidavit, para. 4, Sch. 1). And unless Southwestern Bell can recover the full measure of its costs, its shareholders have no hope at all of obtaining their constitutionally-guaranteed fair return on their investment. (See, FPC v. Hope Natural Gas Co., 64 S.Ct. 281, 288 (1944) ("it is important that there be enough revenue not only for operating expenses, but also for . . . capital costs," including "service on the debt and dividends on the stock"); Duquesne Light Co. v. Barasch, 109 S.Ct. 609, 617 (1989) (rate must allow utility to "compensate its investors for the risk [they have] assumed")). Thus, by itself, this reliance on the costs of an idealized network, creates a grave constitutional difficulty that, under established canons of statutory construction, must be avoided. (E.g., Walter v. United States Dept. of Housing & Urban Dev., 912 F.2d 819, 829 (5th Cir. 1990)).

D. The Unrealistically Low Prices Resulting from the Commission's Approach Will Discourage Facilities-based Competition and Frustrate Congressional Intent.

There is also no policy basis for employing such a novel methodology. To the contrary, basing prices on the forward-looking costs of a hypothetical, ideally efficient network does not encourage competition. Rather, it simply ensures that AT&T and MCI will receive a vast, unearned windfall in the form of below-cost access to Southwestern Bell's network. These competitors will then be able to undercut Southwestern Bell's rates and siphon off customers without ever investing in any new facilities.

Among other goals, Congress anticipated the FTA to create a transition to facilities-based competition where companies would benefit consumers by investing in new technologies to compete with Southwestern Bell's existing network. (Iowa Utilities Board v. FCC, 1997 U.S. App. LEXIS at *93 (while not the FTA's exclusive purpose, Congress envisioned facilities-based competition in local telephone markets to occur down the road). See also, S. Conf. Rep. 104-230, at 1 (1996) (statute would "accelerate rapidly private sector deployment of advanced telecommunications and information technologies"); 142 Cong. Rec. H1174 (daily ed. Feb. 1, 1996) (statement of Rep. Buyer) (statute would result in "tens of billions of private industry dollars being invested in infrastructure and technology"); Notice of Proposed Rulemaking, Order on Remand, and Waiver Order, In re Amendment of the Commission's Rules to Establish Competitive Service Safeguards for Local Exchange Carrier Provision of Commercial Mobile Radio Services. 11 FCC Rcd 16639, 16678-79 (1996) ("the interconnection provisions of the Act, Section[s] 251 and 252, are designed to promote facilities-based local exchange competition")).

The pricing methodology adopted by the Commission thoroughly undermines that goal. The reason is simple. Entrants will never have any incentive to invest in their own technology when they can buy Southwestern Bell's existing facilities at rates which are based on the most efficient and technologically advanced network that can be imagined. There is simply no need to incur the risk of investing capital when the rewards are already given to them in these rates. MCI and AT&T will be able to undercut Southwestern Bell's prices without spending any money at all on new, more efficient facilities.

This ability to undercut Southwestern Bell's price through unbundled network elements is shown in stark terms in the attached affidavit of William Bailey. Unbundled network elements can be used to obtain discounts of 60-75% for business customers and 27-50% for residential customers. (Bailey Affidavit, Sch. 2). Accordingly, as even the FCC has recognized, a methodology like the one used here "may discourage facilities-based competition by new entrants because new entrants can use the [incumbent's] existing network based on the cost of a hypothetical, least-cost, most efficient network." (FCC Order, 11 FCC Rcd at 15848, ¶683). (emphasis added). (See also, Competitive Telcom. Ass'n v. FCC, 87 F.3d 522, 529 (D.C. Cir. 1996) ("rates . . . that do not reflect the full cost of providing that service will discourage competitors with more efficient . . . alternatives from entering the market")).

On the other hand, reliance on Southwestern Bell's actual costs provides precisely the correct signals to potential entrants. In such a circumstance, an entrant will invest in new facilities where it can beat the incumbent's costs and thus provide service more efficiently. Thus, as Professor Alfred Kahn has explained, to "promote efficient facilities-based entry," a ratemaking body must require potential competitors to pay an incumbent's "actual costs" because only that methodology will "fully preserve their incentive" to build their own, more efficient, facilities.[18] In his attached affidavit, Professor Kahn notes:

> Why should any entrant bother to take the risk of constructing its own facilities if it can purchase use of the facilities of the incumbent at prices set by a commission and staff operating under the principle of setting those rates at the lowest possible level of costs of a ideally efficient new entrant? In this most fundamental sense, therefore, the Commission proposed basis for pricing Southwestern Bell's network elements is not only fatally prescriptive but actually anti-competitive.

(Kahn Affidavit, para. 15).

No rational company in a private market jettisons all its equipment the moment a more advanced technology comes along. Rather, such firms accumulate an array of equipment that represents the most efficient technology available at the time they invested. As Professor Kahn explains,

> On the contrary, in a world of continuous technological progress, it would be irrational for firms constantly to update their facilities in order <u>completely</u> to incorporate today's lowest-cost technology as though starting from scratch, the moment those costs fell below prevailing market prices: investments made today, totally embodying the most modern technology available currently, would instantaneously be outdated tomorrow and, in consequence, never earn a return sufficient to justify the investments in the first place.[19]

III. THE COMMISSION MANDATED ADJUSTMENTS TO SOUTHWESTERN BELL'S TELRIC COST STUDY RESULT IN RATES WHICH VIOLATE SECTION 252(d)(1).

Even if it were permissible to ignore actual costs and set prices based on forward-looking costs of an idealized network, the adjustments imposed by the Commission are improper. If

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[18]Alfred E. Kahn Affidavit, para. 9.

[19]<u>Id.</u>, para. 6.

forward-looking costs are an appropriate methodology, the inputs utilized must reflect the investment and cost levels expected on a forward-looking basis. The following represents a few of the adjustments mandated by the Commission which cause the TELRIC based price not to reflect appropriate forward-looking costs.

A. Use of Fill Factors.

One of the largest adjustments to Southwestern Bell's TELRIC costs involve the use of hypothetical fill factors in Southwestern Bell's outside plant, which drives down costs and prices for loops and interoffice transport. The significant impact is demonstrated in the rates for an 8db loop in the attached affidavit of Michael Moore. As demonstrated therein, the use of inappropriate fill factors reduces the rate for an 8db loop by an average of $1.79 per month (plus a common cost allocation on this incremental amount). (Moore Affidavit, para. 2).

The Staff Report on which the Commission set rates contends that Southwestern Bell refuses to utilize forward-looking fill factors and insists upon the use of actual fill factors. This is incorrect. Southwestern Bell's TELRIC studies do utilize forward-looking fill factors, but properly note that Southwestern Bell's network over the two or three-year life of a contract with AT&T and MCI will not experience significant change in the actual fill factors. (Moore Affidavit, para. 2). It is inconceivable that, over the course of two or three years, Southwestern Bell will experience an unprecedented and dramatic increase in its fill factors for its outside plant. To the contrary, to the extent subloop unbundling is utilized by MCI or AT&T, the impact of competition is likely to decrease the fill factor for the feeder portion of the loop, since that is what is most likely to be duplicated by new entrants. (Deere Affidavit, para. 6).

The Staff Report, on which the Commission based its rates, drew an incorrect understanding of the relationship between depreciation lives and fill factors.[20] Fill factors are not derived from or based upon depreciation lives. (Id., para. 4). There is no relationship between the two. (Id., para 5). Instead, fill factors represent how much plant is necessary to be in place to meet obligations to serve customers.

It is vital that the Commission correct the fill factors.[21] The significant financial impact on Southwestern Bell must be recognized, just as it must be recognized that Southwestern Bell has actually placed the plant in service which will be utilized by AT&T and MCI in purchasing unbundled network elements. It is inappropriate to pretend that Southwestern Bell has less plant in place than it actually does, or to pretend that there will be a significant increase in utilization over the two to three-year period of the contract. The Commission should correct this methodological error.

B. TELRIC-Non-Recurring Charge Adjustment.

One of the more significant adjustments to Southwestern Bell's TELRIC studies is the exclusion of 50% of the costs for non-recurring charges (NRCs). These are one time charges which reflect the average level of activity necessary to establish and service an unbundled network element. The Commission accepted the Staff's proposal to arbitrarily exclude half of Southwestern Bell's costs on the theory that (1) there were no time and motion studies and (2)

[20] Final Order, Attachment C. p. 13.

[21] The Commission must also adjust factors like the feeder stub fill which is derived from feeder fill. (Deere Affidavit, para 8).

charges should be kept low to encourage competitive entry.[22] There is absolutely no evidentiary support for the arbitrary exclusion of 50% of the costs which Southwestern Bell expects to incur to provide unbundled network elements, and the resulting prices clearly violate Section 252(d)(1) of the FTA. The Staff Report admits that no support for the 50% adjustment exists, calling the issue one of "burden of proof" (Final Order, Attachment C, pp. 123-124). But when the decision maker (the Commission) has not conducted any proceeding to examine the issues, there has been no failure to meet any "burden of proof" and the criticism misses the mark. The Commission may not arbitrarily exclude 50% of Southwestern Bell's costs on the basis that Southwestern Bell has not met a burden it had no opportunity to meet.

Southwestern Bell's NRCs are developed utilizing input from subject matter experts who are intimately familiar with the work requirements necessary to provide each unbundled network element requested by a competitor. (Lundy Affidavit, para. 6). Time and motion studies would not add any appreciable measure of exactness to the process. (Id.). In any event, the arbitrary exclusion of 50% of the costs of NRC is wholly without any evidentiary support whatsoever.

It is obvious that the Commission accepted the Staff proposal in order to keep costs low for competitors entering the market. While this may be considered reasonable from the perspective of the new entrant, competitive entry cannot be enhanced by requiring the incumbent to provide services at below costs. This is a clear and direct violation of Section 252(d)(1). The Commission should recognize its duties in this regard, and reinstate the level of NRCs reflected in Southwestern Bell's studies. If an LSP considers Southwestern Bell's NRC costs too high, the

[22] Final Order, Attachment C, pp. 123-124.

LSP still has the choice to utilize its own network facilities or to resell Southwestern Bell's services.

C. Non-Recurring Charges - UNE Conversion and Resale Conversion.

Although not entirely clear from the Final Order, it appears that the Commission has instituted a $5.00 charge when AT&T or MCI specifically identifies the unbundled network elements which it wishes to purchase to serve an existing customer with no changes. The rate clearly violates Section 252(d)(1) as it fails to cover an amount even approximating Southwestern Bell's costs.

There are at least two specific problems with the Commission's approach. First, it appears that the Commission is precluding Southwestern Bell from recovering the non-recurring charges for each element ordered by AT&T or MCI. As noted above, the Commission arbitrarily and unlawfully reduced Southwestern Bell's recovery to 50% of its costs. Here, the remaining 50% of the charge appears to be wiped out. But the costs which Southwestern Bell incurs to establish non-recurring charges are real. (Lundy Affidavit, para. 6). The action of the Commission will also have a substantial, discriminatory impact in the competitive marketplace. If, for example, AT&T serves an existing customer by recombining unbundled network elements it would be avoiding all non-recurring charges. On the other hand, if MCI decided to utilize its own switch, but ordered an unbundled loop and cross connect from Southwestern Bell, it would have to pay non-recurring charges for those elements. This discriminatory treatment discourages capital investment by new entrants and is violative of Sections 51.307 and 51.313(a) of the FCC's Interconnection Rules.

This approach also violates Section 251(c)(3) which the 8th Circuit recently ruled "unambiguously indicates that requesting carriers will combine the unbundled elements themselves.[23]" The Commission's determination, however, permits MCI and AT&T to order from Southwestern Bell and escape payment of the non-recurring charges. Contrary to the 8th Circuit's determination that "requiring the requesting carriers to combine the elements themselves increases the cost and risks associated with unbundled access as a method of entering the local telecommunications industry and simultaneously makes resale a distinct and attractive option"[24], the Commission's decision imposes severe cost burdens on Southwestern Bell, while allowing MCI and AT&T to avoid the costs they cause. If not modified, this will incent AT&T and MCI to shift from resale to the purchase of unbundled network elements, as they will be permitted to obtain discounts ranging from 27%-50% for residential customers and 60%-75% for business customers without paying the required non-recurring charge. Bailey Affidavit, Sch. 2.

Second, the Final Order permits Southwestern Bell to recover a service order charge, but arbitrarily limits it to $5.00. Southwestern Bell presented preliminary information to the Staff demonstrating a cost of $25.75 for processing a manual service order request. This is the charge which should apply whenever a carrier chooses to interface on a manual basis. There is no justification whatsoever for limiting cost recovery to $5.00 if an LSP chooses to place its orders manually. Nor does the $5.00 charge cover Southwestern Bell's costs when and if a carrier chooses electronic ordering. The price chosen by the Commission is that in effect for a primary

[23]Iowa Utilities Board v. FCC, supra, at *82.

[24]Id. at *88-89.

interexchange carrier (PIC) conversion, but the work involved in the two areas is not the same, and there is no legitimate basis to adopt that price.

Previously, the Commission also adopted a $5.00 service order charge when a simple resale conversion of an existing Southwestern Bell customer to resale is made. Southwestern Bell provided support for a $25.80 charge when a manual resale conversion service request is submitted by an LSP. Again, there is no justification for limiting Southwestern Bell's recovery to the purported level for electronic ordering when an LSP chooses to place its order on a manual basis. Even when the LSP chooses an electronic method of placing orders, the $5.00 charge should be considered as interim until it can be determined whether the charge reflects Southwestern Bell's actual work activities necessary to make the change. Nor will most carriers undertake the investment necessary to place orders electronically when they can obtain the financial benefits of electronic ordering while continuing to submit manual orders. The manual rate should apply until such time as a carrier processes orders via an electronic method. The Commission also must address a complex resale conversion cost study and set a rate for manual processing and complex conversion for resale.

D. Local Switching Prices - Minutes of Use Growth Factor.

The switching prices established by the Final Order are dramatically short of that necessary to recover Southwestern Bell's actual costs. One of the primary causes of this shortfall is the utilization of a 10% growth factor in minutes of use for each year over the life of the contract.[25] This is inappropriate for two principal reasons: First, Southwestern Bell's historical growth in minutes of use is not consistent with a 10% factor. Over the last three years, Southwestern Bell

[25]Final Order, Attachment C, p. 44.

averaged a 5% per year growth, never achieving a 10% increase in any year. (Lundy Affidavit, para. 5). Second, a substantial number of new competitors are expected to utilize their own switches to provide local service, an occurrence which will drive down the minutes of use which Southwestern Bell continues to switch on its network. (Id.). At least eight companies either have their own switches or have announced plans to install a switch for use in providing local exchange service in Missouri. (Id., Sch. A).

E. Depreciation Adjustment - Failure to Use Equal Life Group Approach.

The Final Order erred in adopting depreciation rates which failed to utilize an equal life group approach. Instead, the Commission adopted a vintage group approach which inaccurately reflects the use of plant over the life of the contract.

As reflected in the attached affidavit of John Lube, academicians uniformly support the use of equal life group rather than the vintage group approach in setting depreciation charges. (Lube Affidavit, para. 4). Moreover, this Commission has, since the early 1980's, utilized the equal life group approach in setting Southwestern Bell's depreciation rates for regulatory ratemaking purposes. (Id., para. 12). Likewise, the FCC, the Interstate Commerce Commission, and many other state commissions have adopted the equal life group approach. (Id.).

Both vintage group and equal life group are methods of grouping items of plant for depreciation purposes. The vintage group method groups items of plant based on the time placed in service. The equal life group, on the other hand, groups items of plant based on the expected life of the plant. (Id, para. 5). The equal life group approach is more representative of actual forward-looking usage since not all items of a particular category of plant live or remain in use for the same period of time. (Id., para. 6). The Staff recommendation, which was accepted by the

Commission, is apparently based upon the mistaken notion that equal life group has not worked. But equal life group depreciation is designed to work vintage by vintage, and it does. (Id., para 9). Increases in the depreciation rates for certain categories of plant are not the result of equal life group modification, but by other factors such as decreases on the projection lives and placement of new plant. (Id., para. 9).

The impact of utilizing vintage group instead of equal life group in establishing depreciation rates affects essentially all of the unbundled network element rates established by the Commission. Whenever capital investment is necessary to provide unbundled network elements, a revision of depreciation rates to reflect equal life group will ultimately impact the cost and price of that unbundled network element. The impact of correcting the use of vintage group depreciation is shown for an 8db loop in the attached affidavit of Michael Moore, para. 2. The Commission should correct this depreciation determination and revise all of the unbundled network element rates accordingly.

F. Exclusion of Inflation Factor.

In the Final Order, the Commission accepted Staff's proposed TELRIC prices which adjusted Southwestern Bell's TELRIC costs by, among other factors, excluding an inflation factor. If a forward-looking TELRIC approach is to be utilized, it is appropriate and necessary to recognize that certain costs are subject to inflationary pressures over the period of the contract. Failure to recognize this increased level of costs results in rates which are below cost in violation of Section 252(d)(1) of the FTA.

The Final Order apparently excluded the recovery of increased expense due to inflation based on Staff's assertion that a productivity adjustment would also be required.[26] The problem with this approach is that productivity gains are implicitly included in a TELRIC study while inflation is not. (Lundy Affidavit, para. 4). Productivity is typically achieved in the telecommunications industry by the utilization of newer and more efficient technology. But since the TELRIC cost studies already adopt the newest and most efficient technology available, the productivity gains which can be expected over the life of the contracts with AT&T and MCI have already been taken into account. (Id.). Inflation, on the other hand, is an increase in items of expense that are expected over the life of the contract. The failure to include an inflation factor in the TELRIC study results in an understatement of forward-looking costs which violates the standard set in Section 252(d)(1).

G. Failure to Adjust Common Cost Allocation.

The methodology adopted by the Commission is based upon a calculation of direct TELRIC costs for each individual unbundled network element with a uniform percentage allocation of joint and common (indirect) costs to determine the proposed rate. The common cost allocator is designed to ensure that the TELRIC approach covers a fair portion of joint and common costs. While the Commission accepted Southwestern Bell's common cost allocator, it made substantial adjustments to Southwestern Bell's TELRIC costs. Most of these adjustments consisted of removing cost items from direct TELRIC costs or lowering the amount of cost allowed for such items. But the Commission made a major methodological error when it failed to

[26]Final Order, Attachment, p. 117.

increase the common cost allocator to reflect the increased level of costs which are considered indirect once removed from the direct TELRIC cost category. (Bailey Affidavit, para. 6).

These costs do not simply disappear when the Commission determines not to recognize them as direct TELRIC costs. There has been no determination or even a claim that these costs were inappropriately incurred. Consequently, these costs must be added to the joint and common costs of the firm, a portion of which must be recovered in unbundled network element pricing through the allocation process. Since the TELRIC method of recovery is based upon allocation of the joint and common costs, it requires the Commission to increase the common cost allocator to reflect the higher percentage of costs considered indirect (joint and common) once removed from the direct TELRIC costs. The failure to adjust the common cost allocator causes the unbundled network element rate to be below the cost of providing the service in violation of Section 252(d)(1) of the FTA.

IV. THE DISCOUNTS FOR RESOLD SERVICES ADOPTED BY THE COMMISSION VIOLATE SECTION 252(d)(3).

Under the Final Order, two distinct wholesale discounts are established: (1) a discount rate of 19.2% for all services other than operator services and (2) a 13.91% discount for operator services. The Final Order violates the FTA in three important respects: (1) the Final Order fails to adopt a service-by-service discount and (2) the Final Order incorrectly sets a discount rate based on costs which the Commission deems "avoidable" rather than those that "will be avoided" as required by the FTA and (3) the methodology is fatally flawed. Each of these three distinct failings cause the resulting discount to be in violation of Section 252(d)(3) of the FTA.

Section 252(d)(3) of the FTA requires that wholesale discounts be established by excluding from the retail rate "the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier." (emphasis added). The effect of the Final Order is to establish the same level of discount for all services (other than operator services) based upon an unsupportable hypothesis that the same percentage of "marketing, billing, collection and other costs" will be avoided on each service. Such an assumption is unreasonable and inconsistent with the requirements of Section 252(d)(3).

As set forth in the affidavit of Barb Smith, the amount of marketing, billing, collection and other costs that will be avoided in the provision of wholesale services varies, depending upon the service involved. (Smith Affidavit, para. 4). Expenditures for marketing services, for example, are not made in the same percentage for each of Southwestern Bell's services. Some services are heavily advertised (e.g., discretionary services like Call Waiting and Caller I.D.), while other services are not. Yet the methodologies adopted by the Commission assumes that such costs are incurred in the same percentage for each of the myriad of services offered by Southwestern Bell. Such an assumption contains no support in the record and runs counter to both intuition and fact.

As the Commission is aware, there is no obligation for AT&T and MCI to resell all of Southwestern Bell's services, nor any obligation to sell the same amount of each such service. By setting the same discount levels for all of Southwestern Bell's services, the Commission's Final Order creates the substantial probability that Southwestern Bell will recover less than the amount required by Section 252(d)(3) because its competitors will choose to sell those services which have a lower level of costs that are truly avoided than is reflected in the uniform percentage of 19.2%. As reflected in Schedule 1 to the affidavit of Barb Smith, residential services typically have a lower percentage of cost avoided than business services. The "averaging" of the discount across all of Southwestern Bell's services means that business services have a higher discount level than is justified by the cost that will be avoided. Competitors, however, may well choose to focus their marketing efforts on business customers rather than residential customers. By taking advantage of the uniform discount rates, these competitors will buy Southwestern Bell's business services at a wholesale rate which is lower than the retail rate minus avoided costs as required by the statute.

The problem is highlighted when reviewing specific services that have zero avoided costs. For example, Southwestern Bell sells Plexar Custom services for which no retail price is developed until the customer actually requests the service. Accordingly, no costs are avoided when a competitor buys Plexar Custom at a wholesale rate from Southwestern Bell and resells it. But Southwestern Bell is nevertheless forced to give a 19.2% discount. The result is that Southwestern Bell is required to sell wholesale services at prices which are lower than its retail rates minus costs which are actually avoided. This violates the statute and cannot be permitted.

The second major flaw in the Final Order determination of wholesale discount rates is its adoption of a standard which assumes that Southwestern Bell will no longer be involved in the retail business. The Final Order is based on this assumption, and thus artificially inflates the level of costs that are claimed to be avoided. In effect, the Commission has adopted a standard which provides a wholesale discount based on costs which are assumed to be avoidable, not costs that actually "will be avoided" as required by Section 252(d)(3). The Staff report which derives the discounts unquestionably utilizes an avoidable cost method, rather than an avoided cost method.

> The process is to determine how much cost is avoidable if an incumbent telephone company were to become a wholesale company. This avoidable cost model was created by the FCC, although states have the ability to adopt an alternate method.[27]

This approach adopted by the Commission is invalid since it arbitrarily and unreasonably assumes that Southwestern Bell will no longer be in the retail business and will operate solely as a wholesaler. But that is not how Southwestern Bell will conduct its business, nor how it will be permitted to conduct its business under regulation by this Commission. Southwestern Bell is under a statutory duty to provide service to all of the customers within its territory and is not permitted to refuse to serve them on a retail basis. Nor does Southwestern Bell intend to limit itself to operations on a wholesale level. It will remain in the retail business and compete. But the methodology adopted by the Commission assumes that all of Southwestern Bell's retail costs will evaporate, and thereby overstates the level of cost that "will be avoided" as established in Section 252(d)(3).

This substitution of "avoidable" costs for "avoided" costs is contrary to the plain terms of Section 252(d)(3). Using a hypothetical measure of costs that "could be avoided" ensures that Southwestern Bell will be unable to fully recover costs that it actually incurs in providing a wholesale service. Real-world costs will be ignored, even if Southwestern Bell incurs them for an entirely valid business reason that is consistent with the requirements of the FTA. The utilization of an "avoidable" cost standard cannot be permitted.

The third major flaw in the calculation of a resale discount involves conceptual mistakes in the methodology employed. The methodology adopted by the Commission attempts to calculate

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[27]Staff Report, p. 178.

avoided costs as a percentage of the total revenues for the services to be resold. In establishing a discount for all services other than operator services, however, the Commission made a critical error in the application of this methodology by including operator services costs as avoidable, thereby increasing the discount for all such services. (Smith Affidavit, para. 9). It is simply erroneous to assume that operator services costs are avoided when a reseller purchases other services such as Caller I.D. or call waiting. Southwestern Bell does not avoid operator services calls when Caller I.D. or call waiting are resold. Including operator services as avoidable costs artificially inflates the discount for all other services. The impact of this error is considerable. When operator services costs are removed from the calculation of the discount for all other services, the rate drops from 19.2% to 13.9%. (Smith Affidavit, para. 13). When other flaws in the methodology are corrected,[28] the aggregate discount for all services other than operator services becomes 10.04%. (Smith Affidavit, para. 10).

Consideration of the following example helps clarify the conceptual error. Assume two carriers wish to compete via resale of Southwestern Bell services. Reseller A chooses to resell Southwestern Bell's operator services in addition to other services, while reseller B chooses to provide its own operator services. Assume that resellers A and B each purchase Caller I.D. and basic residential local services. In each case, the resellers will receive a discount of 19.2% based upon the erroneous assumption that operator services are avoided. But these costs are obviously not avoided for reseller B which is buying Southwestern Bell's operator services. And the costs are not avoided in providing wholesale services to reseller A, since Southwestern Bell is

[28]Smith Affidavit, paras. 14-20. These flaws include considering operator services provided as part of public telephone as avoidable (public telephone is not a resale service) and other costs not avoided when services other than operator services are resold.

continuing to incur those expenses in providing services to reseller B. In short, the Commission has made a major conceptual error including operator services costs as "avoidable" when determining the discounts for all other (non-operator) services.

The Commission has made a similar methodological error in calculating a discount of 13.9% for resold operator services. Conceptually, the Commission should have determined what marketing, billing and collection costs would be avoided if SWBT's operator services were resold. But the Commission did not even examine that question. Instead, the Commission identified the avoidable costs if all services other than operator services were resold. No operator services costs which would be avoided were identified. Had the Commission identified the costs which would be avoided if operator services were resold, it would have determined a discount of 3.15% as determined in Southwestern Bell's service by service study.

V. CLARIFICATION ISSUES.

Southwestern Bell requests the Commission to clarify its Final Order as follows:

A. Charges for Dark Fiber.

The Final Order sets rates for dark fiber on a per strand, per mile basis.[29] Southwestern Bell believes the Commission intended to adopt its charge on a per strand, per foot basis. This is the basis utilized by the Commission in its Initial Order of December 11, 1996. Accordingly, Southwestern Bell requests the Commission to clarify its order to reflect that dark fiber charges

[29] Final Order, Attachment B, p. 4.

are on a strand, per foot basis, as any other result would be clearly confiscatory and not in compliance with Section 252(d)(1).[30]

B. Clarification of Subloop Unbundling Prices.

Southwestern Bell requests the Commission to clarify its decision establishing prices for an unbundled subloop in three respects. First, the Final Order erroneously establishes rates for an unbundled subloop which are less than the rates for the loop itself. (Moore Affidavit, para. 8). This is counter intuitive and clearly reflects a problem with the data. Southwestern Bell believes the problem stems from a failure to include poles and conduits in the charges for an unbundled subloop. (Id.). Second, the subloop prices do not reflect the need for a connection of feeder or distribution facilities to the facilities of MCI or AT&T. (Moore Affidavit, para. 7). This element, and its costs, must be on an individual case basis (ICB) method since neither the interface nor any standards for such interconnection have yet been developed. (Id.). The Commission should clarify that the connection required as an element and sets the price on an ICB basis. Third, there also appears to be a mismatch between the costs and zones for subloop unbundling for 8db, BRI and DS1 loops, both feeder and distribution. (Id.) The Commission should clarify its Final Order and modify the rates for unbundled subloops accordingly.

C. NID Costs.

The Commission's Order fails to establish a price for access to the Network Interconnection Device (NID) unbundled element. Southwestern Bell believes the Commission's Final Order should address this price, and recommends the Commission do so.

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[30]Even when revised to reflect a per foot charge, Southwestern Bell believes the rates do not meet the requirements of Section 252(d)(1).